IV. SWBT'S UNE PRICES IN OKLAHOMA VIOLATE TELRIC

35. As noted above, SWBT's Oklahoma rates were not generated by any analysis of forward-looking costs, but represent only wholly unsupported settlement numbers that one new entrant was willing to accept. Because they were completely unsupported by, and untethered from, any evaluation of the relevant costs, no examination of the stipulated rates could ever support a non-arbitrary finding that they comply with the cost-based rate requirements of the Act and the Commission's rules. The OCC's ALJ could therefore defend the rates only by noting that they are within the very broad "range" established by the competing AT&T and SWBT proposals. Obviously, however, any such "within the range" argument requires that the range be bounded by figures determined by applying the governing legal standard of efficient forward-looking costs (TELRIC). And the upper bound of the range cited by the ALJ was generated by SWBT cost studies that simply ignored core forward-looking principles, as the ALJ's own discussion of the competing proposals confirms. Thus, the mere fact that the numbers lifted from the Cox/Staff stipulation are less than SWBT's grossly excessive proposals provides no legitimate basis for any finding that the stipulated rates are appropriately cost-based.

A. SWBT's Proposed UNE Rates Were Based On Embedded Costs

36. As described above, the TELRIC methodology requires the use of forward-looking costs and precludes "recovery of . . . embedded or accounting costs," which reflect past inefficiencies, older technologies, and inefficient operating practices. *Local Competition Order,* ¶ 621. In general, SWBT's cost studies filed in Oklahoma did not comply

with the TELRIC standard because they assumed investment, network placement, fill factors and expense ratios to be fixed at today's levels. AT&T's cost studies made adjustments to SWBT's cost studies to correct clear violations of forward-looking principles. As AT&T explained, where both proposals use the same cost studies and differ only in that AT&T's proposal reflected SWBT cost studies with forward-looking input assumptions and SWBT's proposal reflected SWBT cost studies with backward-looking assumptions, cost-based rates cannot be reached by stipulating to figures that "split the baby."

37. As we discuss in greater detail below, the ALJ's attempts to justify his "split the baby" approach simply confirm this – the ALJ characterized AT&T's cost proposals as too low precisely because they were based on assumptions that SWBT's network and processes would be more efficient than the network and processes SWBT currently has in place. See *ALJ Report* at 161-67. For example, an issue that the ALJ identified as "the single most influential input to loop investment" (*OCC ALJ Report* at 161) is the "fill" percentage. The lower the fill percentage, the higher the unit cost of investment. With respect to distribution cable, SWBT relied on its "actual current" fill figure, 30%, while AT&T filed evidence supporting a 50% fill factor. The 50% fill factor was based on the premise that competitive firms would not operate in the long run at only 30% of capacity. The ALJ rejected AT&T's fill factor:

> "Again, the Act requires SWBT to unbundle its existing network, not some superior quality network. . . .*See* Section 251 of the Act; *Iowa Utilities Board v. FCC*, 120 F.3rd 753, 812-813 (8th Cir. 1997). A reflection of fill well beyond what is currently available and used by SWBT to provide retail services essentially asks SWBT to provide superior quality facilities to AT&T. For these reasons, the ALJ concludes that AT&T's loop cost proposal is to be given little weight, but not dismissed entirely. It forms the very lowest boundary of cost."

OCC ALJ Report at 161.[8]

38. Non-recurring costs is another significant area in which the ALJ rejected AT&T's proposals because they were based on long run improvements in SWBT's current processes. Non-recurring costs are in large measure a function of the labor required in the ordering or provisioning processes. AT&T's non-recurring cost proposals were based on the assumption that, in the long run, UNE ordering and provisioning would take place electronically. The ALJ rejected this principle:

> "The [electronic handling] assumption, along with the associated estimates of time, flow thru, etc. . . are, at this point, speculative. SWBT identified that manual activity would be needed for all UNE service orders submitted at the present time . . . . Based upon the current record, the ALJ concludes that manual UNE service order activity is the likely option."

OCC ALJ Report at 165.

39. Generally rejecting AT&T's cost studies on this basis, throughout his *Report* the ALJ fell back on his "middle of that which has been proposed by the parties" theory as the justification for finding the prices for individual UNEs to be "cost-based." For example, with respect to unbundled loops the ALJ stated:

> "The ALJ has read the testimony, sifted through the contentions and reviewed the various cost proposals in the record. Future (sic) delineation of each individual disagreement would burden the record unnecessarily (except as discussed with some cost characteristics below). Suffice it to say, it is the ALJ's opinion that all of the cost proposals are within the range of the rate stipulation and therefore the rates are reasonable."

OCC ALJ Report at 162. See also *id.* at 163 (local switching rates approved because they fall between AT&T and SWBT proposals); 166 (labor rates approved because they fall between

[8] By contrast, as described below, when faced with the identical issue, the KCC adopted a fill factor of 53%.

AT&T and SWBT proposals): 167 ("depreciation lives is of relevance and material but given the ranges, is amply addressed within the stipulation results which reduce recurring costs (where the cap cost is applied) considerably").

1. Fill Factor For Unbundled Loops

40. The ALJ labeled fill factor as "the single most influential input to loop investment." *OCC ALJ Report* at 161. With respect to unbundled loops, the parties' disagreement focused on the utilization or fill factor to be used in connection with distribution cable. In its cost study, SWBT used a 30% fill factor based on its current fill factor (which ranges from [] to []%). Thus, SWBT assumed that SWBT's distribution plant is less than one-third full and is expected to remain at that level in the future. However, SWBT's current 30% utilization in Oklahoma reflects usage following many years of rate of return regulation. An efficient firm operating in a competitive environment would not maintain such a high level of spare capacity. In its cost study, AT&T assumed a fill factor of 50%. Similarly, Liberty, on behalf of the OCC Staff, recommended distribution fill factors of 44% for urban and suburban areas and 60% for rural areas.[9] A 50% distribution fill factor is conservative compared with the distribution fill inputs by density zone to the FCC's Synthesis Costing Model, which uses distribution input fills ranging from 50% in the lowest density zone up to 75% in the most dense service territories.[10] As noted above, the Commission has made clear that networks are to be

[9] *OCC ALJ Report* at 78. Liberty Consulting's Direct Testimony on behalf of the OCC Staff in the Oklahoma pricing proceedings is appended hereto as Attachment 4.
[10] Computer Modeling of Local Telephone Network, FCC, October 1999 at 24-25.

sized to meet the "current demand," which includes only the amount of excess capacity needed to meet short term growth.[11]

41. In rejecting AT&T's proposed fill factor for distribution cable (and implicitly rejecting Liberty's proposal as well), the ALJ held that "the Act requires SWBT to unbundle its existing network, not some superior quality network. . . [citations omitted] A reflection of fill well beyond what is currently available and used by SWBT to provide retail services essentially asks SWBT to provide superior quality facilities to AT&T." *OCC ALJ Report* at 161. SWBT's use and the ALJ's endorsement of an assumption that 70% of SWBT's distribution cable will remain spare capacity in the long run flies in the face of this Commission's statement that fill factors should reflect "the proportion of a facility that will be 'filled.'" *Local Competition Order* ¶ 682 (emphasis added).

42. Moreover, the Oklahoma ALJ's resolution of this critical issue stands in stark contrast to the KCC's analysis of the same issue. The KCC directed SWBT to use a 53% fill factor for distribution cable, stating:

> "In determining the fill factor, future utilization of the facilities should be considered. Staff's recommendation to use the mid-point fill factor reflecting increased utilization over time is reasonable. . . . One factor to consider in projecting distribution fill is the increase in second lines. Historical data shows an increase in second lines. . . . Staff's recommended distribution fill factors represent reasonable utilization rates on a long-term forward-looking basis."

KCC Inputs Order at A-27.

[11] Tenth Report and Order, In The Matter Of Federal-State Joint Board On Universal Service, CC Docket No. 96-45, Forward-Looking Mechanism For High Cost Support For Non-Rural LECs, CC Docket No. 97-160, FCC 99-304, 14 FCC Rcd. 20,156 (Rel. Nov. 2, 1999), ¶¶ 189-90; ¶¶ 200-203.

2. Fill Factor For Dedicated Transport

43. A similar pattern was repeated with respect to the fill factor for dedicated transport. In its cost studies, SWBT used its "actual" current fill factors of [ ]% for terminal equipment and [ ]% for fiber. AT&T, by contrast used "objective" fill factors (also provided by SWBT), of []% for both terminal equipment and fiber, which reflects the long term utilization that engineers design the network to achieve. Use of the objective fill level reflects properly both the ease with which the modular terminal equipment plug-in equipment can be added when additional capacity is required and the inherent scalability of fiber. Liberty agreed with AT&T, stating:

> "Staff does not believe that actual fills are appropriate to use in a TELRIC cost study unless SWBT can demonstrate that those actual fills are optimal, that is, the most appropriate in a modern, forward-looking, efficient network. SWBT has not done that in this case. Accordingly, Staff has determined its prices on the basis of SWBT's objective fill factors. . . "

Direct Testimony of Paul P. Hlavac (Attachment 4 hereto) at 14.

44. Once again, the ALJ adopted SWBT's current fill factors:

> "Objective fill may never be reached and is forward looking only in that it is speculative about what might be achieved. Whether objective fill actually is achieved differs in many engineering cases."

OCC ALJ Report at 165. The Oklahoma ALJ's use of embedded fill factors conflicts with forward-looking TELRIC principles. By contrast, the KCC, when presented with the identical issue held that SWBT's engineering fill factor "better reflects forward-looking conditions than actual fill and is therefore appropriate for use in a TELRIC cost study." *KCC Inputs Order* at A-88 – 89.

3. Non-Recurring Costs

45. As the name implies, non-recurring costs or charges (NRCs) are one-time expenses incurred in the ordering and provisioning of UNEs. Unlike recurring charges, NRCs do not have investment associated with their cost development. Rather, these costs are developed by determining the amount of time necessary to perform a function and multiplying that amount of time by the appropriate labor rate. For example, the NRC for performing a copper loop to collocation area cross-connect (running the jumper wire from the frame) is developed by determining the amount of time it takes to run the jumper wire and multiplying that time by the labor rate for the craft 1 technician who performs that work.

46. With respect to ordering and preordering, SWBT's cost study assumed a completely *manual* process where the new entrant faxes or phones in the order and the SWBT service representative enters all of the data into the computer. This assumption directly conflicts with SWBT's obligation under the 1996 Act to provide electronic interfaces for ordering and preordering and the requirement that efficient technology and processes be used under the TELRIC standard. Accordingly, in its cost study, AT&T assumed that ordering and preordering would be performed electronically.

47. The ALJ sided with SWBT on this issue. Citing the fact that, as of 1998, electronic interfaces were not yet completely in place or in use, the ALJ found the assumption of electronic ordering and preordering to be "speculative" (despite SWBT's obligation to provide electronic processes to provide reasonable access to its OSS) and that the costs associated with the current manual ordering and preordering processes should be used:

> "Based upon the current record, the ALJ concludes that manual UNE service order activity is the likely option. If new changes occur, those should be adjusted and recognized in future studies when data is available."

OCC ALJ Report at 165. The ALJ's decision on this issue is plainly inconsistent with TELRIC, which requires costs based on a forward-looking, long-run perspective. The KCC recognized this principle in stating:

> "Staff and AT&T have persuasively argued that charges for NRCs should not be based on inefficient manual processing systems. Manual processing is not consistent with TELRIC principles requiring forward looking least cost methods. . . .Obviously, costing of manual methods does not reflect the efficiencies and costs for electronic processing of service orders. Furthermore, assumption of manual service order processing to any significant degree provides SWBT with a large economic incentive to delay implementation of electronic service order flow through, with attendant negative consequences for the development of competition."

KCC Reconsideration Order at 28.[12]

48. An essentially similar pattern was seen with respect to NRCs associated with the provisioning of UNEs. AT&T's proposed costs were based on processes that minimized the amount of manual intervention required by SWBT employees. By contrast, SWBT's witnesses testified as to the level of manual intervention that was required to provision service in 1998. Again, in conflict with TELRIC, the ALJ found that NRCs based on provisioning services for the embedded network, rather than long-run more efficient technology and practices should be used:

> "AT&T's proposal does not represent the activity for the network which SWBT is asked to unbundle. Thus, AT&T's assumptions on DIP/DOP and IDLC, which

[12] However, as we discuss below, in its *NRC Order*, the KCC inexplicably established rates inconsistent with the principles just quoted.

> impact the amount of physical activity, are not representative of the SWBT network. SWBT is not obligated to engage in this quality upgrade."

OCC ALJ Report at 166.

4. Plant Lives

49. The costs of many of the UNEs being priced in this proceeding are determined in large part by the capital investment that is assumed to be required to provide the element. That capital investment must be depreciated, and plant lives are used to determine the time over which depreciation expenses are recovered. Shorter lives will make the recurring costs higher, while longer lives will make the recurring costs lower.

50. The Commission's rules require the use of "economic depreciation rates." 47 C.F.R. § 51.505(b)(3). The rules also mandate that the costs of rate elements "should be measured based on the use of the most efficient telecommunications technology currently available and the lowest cost network configuration." *Id.* § 51.505(b)(1). Thus, the proper measure of costs and associated plant lives must reflect new, efficient equipment purchased at prices realistically available to SWBT. In State and Federal depreciation proceedings, such plant lives are termed "projection lives" to differentiate them from "remaining lives" and "average service lives" which reflect past plant placements.

51. Pursuant to federal statute, 47 U.S.C. § 220(b), this Commission has been prescribing depreciation rates for telephone companies for over 50 years. The projection lives prescribed by the Commission are forward-looking. Over a decade ago the Commission directed its staff to put less emphasis on historic data in estimating productive lives, and to pay "closer

attention to company plans, technological developments and other future-oriented analyses."[13] Recently, the Commission reaffirmed its forward-looking orientation in connection with the simplification of its depreciation represcription practices. The Commission prescribed a range of projection lives which could be selected by carriers for prescription on a streamlined basis and stated that these ranges were based upon "statistical studies of the most recently prescribed factors. These statistical studies required detailed analyses of each carrier's most recent plant retirement patterns, the carriers' plans, and the current technological developments and trends."[14] As such, this streamlined represcription practice assures the development of projection lives that allow forward-looking capital recovery.

52. Accordingly, AT&T's cost studies used the Commission's projection lives, which were also the projection lives prescribed by the OCC at the time of the studies. By contrast, SWBT used projection lives it generally uses for financial reporting purposes. Attachment 5 hereto compares the lives used by SWBT to those prescribed by the Commission. For the key accounts (digital switching, digital circuit and outside plant), the lives used by SWBT are much shorter that those prescribed by the Commission, resulting in significantly higher costs and UNE rates.[15]

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[13]Report on Telephone Industry Depreciation, Tax and Capital/Expense Policy, Accounting and Audits Division, Federal Communications Commission, April 15, 1987 ("AAD Report"), p. 8.
[14]FCC, Simplification of the Depreciation Prescription Process, CC Docket No. 92-296 ("Prescription Simplification" proceeding) Third Report and Order, FCC 95-181, released May 4, 1995, ¶ 11.
[15] SWBT's advocacy of short plant lives also conflicts with its use of low fill factors, which presumably are based on an assumption that abundant spare plant will be available over a long period of time.

53. The ALJ recognized that the plant life issue was highly significant but, instead of resolving it on its merits, in a single conclusory sentence simply fell back on his "split the baby" theory:

> "The matter of depreciation lives is of relevance and material but given the ranges, is amply addressed with the stipulation results which reduce recurring costs (where the cap cost is applied) considerably."

OCC ALJ Report at 167. Thus, the ALJ essentially failed to address at all an issue that he himself recognized has a "material" impact on SWBT's UNE rates.

54. By contrast, the KCC rejected SWBT's use of shorter plant lives:

> "[T]he FCC-authorized (and state-approved) SWBT depreciation rates for Kansas reflect forward-looking considerations and should be used in the TELRIC cost studies."

KCC Inputs Order at A-43 – 44. Similarly, numerous other State Commissions have used FCC-prescribed projection lives for use in TELRIC calculations.[16] Moreover, this Commission has also stated that:

> "We can think of no reason why incumbent LECs should be permitted to use different depreciation rates for different regulatory purposes."[17]

5. Common Costs

55. Common costs are firm level costs that are required to produce two or more of a firm's outputs and that do not vary with the level of only one of the outputs. Costs

[16] See, e.g., Texas PUC Docket 16189, et al., November 7, 1996; Massachusetts Docket DPU 96-73/74, 96-75, 96-80/81, 96-83, 96-94-Phase 4, December 4, 1996; New York PSC Docket 95-C-0657, 94-C-0095, 91-C-1174, April 1, 1997; West Virginia PSC Docket 96-1516-T-PC, April 21, 1997; Wyoming PSC Docket 70000-TF-96-319, 72000-TF-96-95, April 23, 1997; Delaware PSC Docket 96-324, April 29, 1997; Ohio PUC Docket 96-922-TP-UNC, June 19, 1997; Michigan PSC Docket U11280, July 14, 1997; Colorado PUC Docket 96S-331T, July 28, 1997; Maryland PSC Docket 8731 (Phase II), September 22, 1997; Louisiana PSC Docket 22022/22093-A, October 27, 1997.

typically recognized as common costs include executive and planning, accounting and finance, external relations, human resources, information management, legal and other general and administrative costs. Common costs are accounted for in SWBT's cost studies through the application of a Joint and Common Cost factor.

56. SWBT developed its Joint and Common Cost factor in a manner that is inconsistent with a forward-looking cost study. Specifically, SWBT calculated its factor as the relationship of common costs to total *expenses*. Because this factor is applied to costs that include return on capital, depreciation and income tax expenses, it should be based on the relationship of common costs to *revenues*. The OCC Staff/Liberty recognized this point in stating:

> "[T]the proper denominator is revenues rather than total expenses. SWBT objects to using revenues as the basis for distributing common costs because, among other things, it would include SWBT's success in marketing high margin services and includes profits in excess of simply a return on capital. it is Staff's position that the way SWBT calculated the common cost factor overstates the amount assigned to network elements because it is not applied to a cost that has a similar basis."

Direct Testimony of Robert L. Stright (Attachment 4 hereto) at 37. The Texas Public Utility Commission likewise determined that the common cost factor should be determined on the basis of revenues, not expenses.

57. Moreover, SWBT also improperly included expenses that should not be assigned to forward-looking UNE's. These include wholesale marketing expenses and cost for retail resold services. As Staff/Liberty pointed out:

[17] Price Cap decision, Docket 94-1, 96-262, May 21, 1997, footnote 122.

> "Wholesale marketing expenses should not be included in the common costs. SWBT used 1995 wholesale marketing costs to calculate this factor. It was not marketing network elements (as that term is relevant here) in 1995. Costs incurred to market something other than the elements at issue here should not be assigned to the elements at issue here."

Direct Testimony of Robert L. Stright (Attachment 4 hereto) at 38. Both Staff/Liberty and AT&T also pointed out that SWBT failed to adjust its historic cost data to reflect forward-looking efficiencies to be gained or the declining trend in overhead costs. *Id.* at 39. Nor did SWBT make any adjustment to incorporate the anticipated benefits of the planned SBC merger with Pacific Telesis.

58. AT&T corrected the deficiencies in the SWBT Joint and Common Cost factor. The AT&T correction resulted in a reduction in forward-looking UNE costs of approximately seven percent.[18] The ALJ rejected this adjustment, stating that it was too "speculative," and thus made *no* adjustment to reflect the factors identified by both AT&T and the OCC Staff/Liberty. *OK ALJ Report* at 167. By contrast, faced with essentially an identical record, the KCC adopted a 10% common cost factor to account for these issues. *KCC Inputs Order* at A-28.

6. Switch Discounts

59. Switch discounts, as the name suggests, represent the discount SWBT will receive off the list price of switches from the manufacturer. These discounts can be large, hence

[18] SWBT proposed a joint and common cost factor of 18.46%. The corrections introduced by AT&T reduced the common cost factor to 10.46% -- a level consistent with the 10% joint and common cost factor adopted by the KCC. The impact of AT&T proposal on UNEs is diluted. (1.1046/1.1846)-1)= -6.8%.

the level of switch discounts has a direct and significant impact on forward-looking switch investment.

60. SWBT claims to have used current switch list prices and the effective discount it receives from switch vendors to develop switching investment. However, at the time the cost studies were developed, SWBT was in the final stages of negotiating new contracts for switch purchases from Lucent Technologies and from Nortel. With increased leverage of the SWBT combination with PacBell, it was likely that the new switch discounts resulting from the negotiations would be even more favorable to SWBT – a conclusion shared by the OCC Staff/Liberty.[19] Even more strikingly, the switch investment per line SWBT included in its Oklahoma cost study was considerably higher than the price SWBT had admitted paying for switches in Texas.

61. In the Texas arbitration proceeding, Hugh Raley, a SWBT witness, testified about the costs that SWBT incurred to install its most recent switches. While this testimony was filed in Texas, SWBT has admitted that [

x].[20] For large switches, the "Engineered, Furnished and Installed" (EF&I) price was $85/line,[21] for medium sized switches, the price was $115 and for smaller switches, it was $140 per line. Another benchmark is provided by the Northern Business Information (NBI) study, "U.S. Central Office Equipment Market, 1995 Database,"

[19] Direct Testimony of Paul P. Hlavac Attachment 4 hereto) at 4.
[20] Deposition of Jay Bishop at 7 (attached as Exhibit CEP-5 to the Direct Testimony of Catherine E. Petzinger in OCC Cause No. PUD 97-213). The Petzinger Testimony is appended as Attachment 6 hereto.
[21] Direct Testimony of Hugh W. Raley, 9/6/96, Docket Nos. 16189, 16196, 16226, 16285 16290; p. 7 (attached as Exhibit CEP-6 to the Direct Testimony of Catherine E. Petzinger in OCC Cause No. PUD 97-213).

which states that average bundled price for RBOC digital switches per line shipped in 1995 was $102, $99 in 1996, $96 in 1997 and $93 in 1998.[22] By contrast, in the Oklahoma pricing proceeding, SWBT applied an average cost per line of $[ ] – an amount higher than even the highest cost per line SWBT testified to in Texas and significantly higher than the NBI prices for switches.

62. AT&T corrected the switch discount in the SWBT Oklahoma study to reflect the average investment per line SWBT admitted to paying for switching investment. In basing forward-looking costs on the *historical* prices SWBT paid for switches, AT&T likely overstated switch investment by not including the higher discounts anticipated from the ongoing contract negotiations.

63. The ALJ rejected any adjustment to SWBT's inflated switch costs, stating that any such adjustment would be "speculative" and would not take into account alleged future increases in the list prices for switches. *OCC ALJ Report* at 162-63. Thus, the ALJ not only adopted embedded rates for switches, but inflated embedded rates. The ALJ's concern about future increases in the list prices for switches is belied by the historical trend in switching investment per line which, like computers, has been declining each year. For example, the NBI study referenced above shows steadily *decreasing* prices for switches between 1995 and 1998.

[22] All switch prices are quoted as prices paid to the vendor just for EF&I switch equipment and do not include taxes or telephone company installation. Bundled is the term NBI uses to define a new switch placement and includes hardware and software.

B. Splitting The Baby Does Not Satisfy The TELRIC Requirement Of Cost-Based Ratemaking

64. SWBT's use of its current network and processes as both the starting and end points of its calculation of costs directly conflicts with this Commission's clear mandate that TELRIC methodology rejects the "recovery of costs other than forward-looking economic costs, . . . including . . . embedded or accounting costs." *Local Competition Order* ¶ 621. As such, SWBT's proposed rates could not properly serve as an upper boundary for TELRIC-based rates. Rates in conflict with TELRIC cannot reasonably serve as guide to identifying TELRIC-based rates.

65. Similarly, the ALJ's explanation for rejecting many of AT&T's proposed UNE rates -- that they reflected more efficient facilities or processes than SWBT used in 1998 -- flatly conflicts with this Commission's requirement that UNE prices be based on TELRIC reflecting "the most efficient telecommunications technology currently available and the lowest cost network configuration." 47 C.F.R. §51.505(b)(1). Accordingly, the basis for the ALJ's finding that the AT&T's proposed rates could serve only as a "lower boundary" for his rate analysis was plainly in error. Rates developed consistent with the TELRIC standard should not serve as a lower boundary for TELRIC-based rates -- they are TELRIC-based rates.

66. Moreover, even if the ALJ was correct in finding that SWBT's proposed rates were too high and AT&T's proposed rates were too low, there is no basis for concluding that *any* rate falling between the two proposals is cost-based and consistent with TELRIC. The ALJ found each and every rate included in the proposed settlements to be consistent with TELRIC, including rates for elements not explicitly discussed in his *Report*. As quoted above,

his "reasoning" in many instances began and ended with the observation that the settlement rates fall between the rates proposed by SWBT and AT&T. As such, the OCC's decision adopting the ALJ's analysis cannot stand.

C. The OCC ALJ's Failure To Follow TELRIC Has Resulted In UNE Rates Far In Excess Of TELRIC

67. The ALJ's failure to adhere to the forward-looking cost principles embodied in TELRIC have had an entirely predictable result: SWBT's UNE rates for Oklahoma are far in excess of TELRIC. This conclusion is supported by at least three different benchmarks. First, prior to the hearing, the OCC Staff had retained the Liberty Consulting Group (Liberty) to review the cost studies filed by SWBT and AT&T and identify areas where adjustments should be made to produce UNE rates in compliance with federal and Oklahoma law. Liberty prepared written testimony to carry out its work. However, at the hearing, Staff announced that it would not introduce Liberty's testimony. Subsequently, Staff counsel announced that he was asked by his client to move for introduction of the Liberty testimony. The ALJ denied the motion. The hearings concluded and the ALJ notified the parties by telephone that he was recommending approval of the Cox/Staff stipulation and directed the parties to prepare a draft written recommendation. On April 18, 1998, as the draft was being prepared, the OCC ordered the ALJ to reopen the record for the submission of the Liberty testimony and exhibits.

68. During the course of the Oklahoma cost proceedings, Liberty Consulting requested ATT to rerun the SWBT cost studies with certain inputs and assumptions which represented the inputs and assumptions that Liberty believed were appropriate for a properly

conducted cost study in compliance with the provisions of the 1996 Act and the Oklahoma costing rule (OAC Section 165:55). AT&T reran the SWBT cost studies pursuant to the directives and instructions of Liberty Consulting. As reflected in Attachment 7, the split-the-baby UNE rates approved by the ALJ and subsequently adopted by the OCC substantially exceed the rates that the OCC Staff's own consultants believed were cost-based. Table 1 compares the results for major UNEs of the restatement of the SWBT cost studies using OCC Staff/Liberty recommended inputs with the UNE rates adopted by the OCC.

TABLE 1
COMPARISON OF RESTATED UNE RATES USING STAFF/LIBERTY INPUTS WITH RATES ADOPTED BY OCC

Description	Rate Adopted By OCC	Restated Rate Using Staff Recommended Inputs
Loop 2- Wire Analog		
Zone 1	$35.00	$24.47
Zone 2	18.00	14.27
Zone 3	13.00	10.84
Local Switch Usage – Stand.		
Zone 1	$0.003800	$0.003473
Zone 2	0.002516	0.002020
Zone 3	0.002268	0.001818
Analog Line Port		
Zone 1	$2.58	$1.28
Zone 2	2.21	1.22
Zone 3	2.18	1.20
Common Transport		
Zone 1	$0.000499	$0.000323
Zone 2	0.000282	0.0001828
Zone 3	0.000266	0.0001724

69. Second, the KCC's decision on UNE charges also provides an illuminating bench-mark. The records in Oklahoma and Kansas were mirror images. The

SWBT cost model was used in both States and SWBT and AT&T approached cost issues in Oklahoma in essentially the same way they addressed those issues in Kansas. Indeed, as reflected in Attachment 5 hereto, in a number of instances, SWBT's proposed rates for Kansas exceeded those for Oklahoma, suggesting that, at least in SWBT's view, the extent TELRIC mandated any difference between Oklahoma and Kansas rates, the Oklahoma rates should be *lower*. The Commission recognized the cost similarities between Kansas and Oklahoma when it first published loop proxy rates in *Local Competition Order*. For Kansas, the proxy loop rate was $19.85, compared with $17.63 for Oklahoma. More recently, the National Exchange Carrier Association's 1999 Submission of 1998 Study Results, which is published on the Commission's website, shows an annual SWBT cost per line in Kansas of $271.57 compared with $246.14 in Oklahoma. These patterns suggest further that Oklahoma UNE rates should be comparable to, if not lower than, those in Kansas.

70. However, because the KCC and OCC applied dramatically different rate-setting methodologies, the Kansas recurring UNE rates were ultimately set far below those set in Oklahoma. As reflected in Attachment 2 to this Declaration and Table 2 below, the UNE rates resulting from the KCC's decision-making are substantially lower than the rates for the same elements in Oklahoma.

FCC DOCKET CC NO. 00-217
DECLARATION OF MICHAEL R. BARANOWSKI AND ROBERT P. FLAPPAN

TABLE 2
COMPARISON OF UNE PRICING IN KANSAS AND OKLAHOMA (monthly recurring charges)

UNE/SERVICE	KS ZONE 1	KS ZONE 2	KS ZONE 3	OK ZONE 1	OK ZONE 2	OK ZONE 3
LOOP 2WIRE ANALOG	$23.34	$13.64	$11.86	$35.00	$18.00	$13.00
LOOP 2WIRE DIGITAL	$40.69	$29.50	$32.66	$72.87	$47.60	$41.14
LOCAL SWIT. STAND/PER ORIG OR TERM MOU (EXCLU. PORT)	$0.00253	$0.00169	$0.00131	$0.003800	$0.002516	$0.002268
CUSTOMIZED ROUTING UNE AIN PER QUERY PER CUST. LINE	$0.00044	$0.00044	$0.00044	$0.009309	$0.009309	$0.009309
ANALOG LINE PORT	$1.61	$1.61	$1.61	$2.58	$2.21	$2.18
BRI LINE PORT	$4.83	$4.83	$4.83	$5.70	$5.70	$5.70
PRI LINE PORT	$143.98	$143.98	$143.98	$181.83	$181.83	$181.83
TANDEM SWITCHING PER MOU PER CALL	$0.000789	$0.000789	$0.000789	$0.000956	$0.000956	$0.000956
BLENDED TRANSPORT PER MOU	$0.000475	$0.000429	$0.000401	$0.000972	$0.000909	$0.000607
COMMON TRANSPORT TERM. MOU	$0.000196	$0.000171	$0.000157	$0.000499	$0.000282	$0.000266
MULTIPLEX VG TO DS1	$119.03	$119.03	$119.03	$182.83	$182.83	$182.83
MULTIPLEX DS1 TO DS3	$359.83	$359.83	$359.83	$632.51	$632.51	$632.51

71. Third, the accompanying declaration of Michael Lieberman demonstrates that the Oklahoma UNE rates are far too high to allow profitable UNE-based entry in Oklahoma. Given that SWBT's local operations are undeniably profitable, that provides still further evidence that the approved UNE rates in Oklahoma are not cost-based.

V. SWBT'S NON-RECURRING CHARGES FOR UNES IN KANSAS VIOLATE TELRIC.

72. In its 1999 *Final Order* the KCC "agree[d] with AT&T" that NRCs should be based "on the assumption that all orders are processed electronically" with "a low fall-out rate" and that "an assumption of 100% DIP [or Dedicated Inside Plant] is appropriate." *KCC Final Order* at 31-32.[23] Apparently believing that SWBT's cost studies largely conformed with these critical forward-looking assumptions, the KCC established very high NRCs "within the range proposed by the parties." *See id.* at 32 & Attachment B.

73. On reconsideration, the KCC recognized that this was not the case and that "SWBT's proposed NRCs are in most cases overstated." *KCC Recon. Order* at 26. The KCC ordered SWBT to "rerun NRC studies" and to "use a fall out rate of 5%," to "assume electronic processing," and to "assume a 100% Dedicated Inside Plant (DIP) and an 80% Dedicated Outside Plant (DOP) factor." *Id.* at 27. *See also id.* (noting that "both SWBT and AT&T seem to acknowledge" that a "1-2% fall out rate" is achievable in the long run); *id.* at 28 ("Staff and

[23] "DIP and DOP refer to the situation where facilities are dedicated to customers and the telephone plant is permanently wired into the network at the central office switches (DIP) and in the cabling from the central office to the customer premises (DOP). . . . SWBT already uses DIP (i.e., SWBT leaves the loop and port connected) for its own internal operations. This procedure minimizes the inefficiencies when one SWBT customer replaces the original one. . . . It would be illogical and inconsistent to use a different assumption for calculating NRCs associated with (continued . . .)

AT&T have persuasively argued that charges for NRCs should not be based on inefficient manual processing systems"); *id.* at ¶¶ 69-70 ("electronic processing is a reasonable assumption for calculation of non-recurring costs, which is consistent and arguably required under the TELRIC costing principles which this Commission and the FCC have adopted").

74. As noted above, SWBT simply ignored these directives. *See KCC NRC Order* at 13 ("Staff notes that in spite of direct language in Commission orders, SWBT submitted a cost study based on fully manual processes"); *id.* at 27 ("The Commission specifically directed SWBT to use a fall out rate of 5 percent"); *id.* at 14 ("Beyond the electronic service order cost study, SWBT continues to make a variety of assumptions regarding fallout"); *id.* at 15 ("The Commission required the use of a 100 percent DIP factor in calculating non-recurring costs. According to staff, it could find no evidence that SWBT complied with this provision of the Order on Reconsideration"); id. at 35 ("SWBT should have complied with the Commission's orders in this case"). Incredibly, given the KCC's Reconsideration Order finding that the resubmission of cost studies was necessary because SWBT's original proposals were "overstated," the prices set forth "in SWBT's re-submitted cost study are significantly *higher* than the prices submitted in SWBT's original cost studies." *Id.* at 41 (emphasis added).

75. SWBT's studies were also rife with other irregularities. *See, e.g., id.* at 25 ("SWBT cannot provide any objective verification for its labor cost assumptions except for the hourly rate charged" and "for those functions requiring labor, it appears that SWBT has overstated costs associated with labor"); *id.* at 22 ("The Commission notes that SWBT's cost

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those same UNE elements." *KCC Recon. Order* at 29.

studies filed electronically in many instances do not match the paper copy filed with the Commission. Many of the studies utilize calculations not contained within the electronic files provided").

76. The KCC recognized that SWBT's approach and its proposed NRCs remained fatally inconsistent with core forward-looking costing principles:

> The Commission specifically directed SWBT to use a fall out rate of 5 percent because the fall out of business orders from automated processing procedures in a business environment will result in additional manual handling (employee time), ill will and customer complaints, and ultimately the loss of business. These results would not be tolerated in a competitive environment. . . . As a regulatory policy matter, it is important to adopt forward-looking least cost standards to avoid institutionalizing disincentives that have an anti-competitive effect and lead to poorer service for consumers. Assumed high fall out rates reward imprudence and inefficiency; high fallout rates have the consequence of added cost for competitors as well as delays and poor service for customers. This is not the expected result of competitive telecommunications markets, so high fallout rates will not be assumed in the non-recurring cost studies. Also, the Commission found that non-recurring costs should not be based on inefficient manual processing systems, which is not consistent with TELRIC principles requiring forward-looking, least cost methods.

Id. at 27. *See also id.* at 32 ("Both Birch Telcom and AT&T have invested substantial sums of money to eliminate the high cost of manual processing and become more efficient service providers. UNE prices should reflect the current state of technology for such processes").[24]

[24] The KCC complained that AT&T did not provide cost analyses for some NRCs and instead "merely multiplied SWBT's proposed cost times the 5 percent fall out factor to determine a recommended price." But that was entirely appropriate. All or virtually all of the costs SWBT proposed for those NRCs were labor costs associated with manual processes which SWBT – in direct contravention of the KCC's orders and TELRIC principles – assumed would occur 100 percent of the time. Correcting for that error requires as AT&T proposed taking 5 percent of the SWBT proposal, to reflect the fact that manual process should be required in only 5 percent of the cases. Moreover, as the Staff discovered, AT&T made an important error in SWBT's favor which served to significantly overstate costs – "both AT&T and SWBT applied the fall out factor
(continued . . .)

77. Rather than remedy SWBT's refusal to comply with clear and direct Commission orders by accepting AT&T's TELRIC-based proposals or ordering SWBT to rerun its studies yet again, however, the KCC used the concededly unlawful SWBT proposals to set permanent NRCs to be incorporated into all existing and future interconnection agreements. In some cases, the KCC accepted SWBT's proposal as is. *See KCC NRC Order*, Attachment B at 10 n. 8. In other cases, the KCC left the NRCs unchanged from the 1999 Final Order, notwithstanding its Reconsideration Order finding that those rates were generally "overstated." *See id.* at 10 n. 1. And for the majority of important NRCs, the KCC employed an entirely arbitrary "split the baby" approach setting the NRC at weighted average of the AT&T and SWBT proposals (2/3 AT&T and 1/3 SWBT). *See id.* at 10 n.2. The KCC did not even attempt to support these determinations as cost-based.

78. The KCC frankly conceded that its motivation for throwing up its hand in this fashion was its public commitment to support SWBT's 271 application and its recognition that approval of that application would necessarily require final, approved NRCs (that SWBT could then label "cost-based"). *See id.* at 24 ("the [KCC] agreed to support SWBT's [section 271] application premised, in part, on the expectation that final permanent prices for UNEs, including the non-recurring charge component, would be in place and available to CLECs").

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of 5 percent to individual activities, rather than looking at the net fall out rate for an entire process within a study." *KCC NRC Order* at 29. This error was largely attributable to SWBT's failure to comply with the KCC's order requiring SWBT to convert its studies to a PC-based format which could be readily modified by analysts. SWBT's explanation for this failure was that converting its studies to a PC-based format would result in "new" studies whereas the KCC had only ordered SWBT to perform "revised" studies.

(continued . . .)

79. The end result of this arbitrary process was permanent NRCs that far exceed cost-based levels. Because of SWBT's clearly erroneous manual processing, fallout and DIP/DOP assumptions, SWBT's rate proposals were many times higher than AT&T's TELRIC-based proposals, and thus even weighting SWBT's study at 1/3 had the effect of more than doubling the resulting rates above cost-based levels.

80. This is obvious when the Kansas NRCs are compared to SWBT's NRCs in Texas where the Commission largely rejected SWBT's unlawful NRC proposals. As the KCC recognized, "NRCs should not be expected to vary significantly across SWBT's jurisdictions because the activities associated with the NRCs are expected to be very similar across these jurisdictions." *KCC Recon. Order* at 26. "The labor rate and time it takes to perform the operations would not be expected to vary significantly. It is Staff's understanding that SWBT has established a centralized CLEC service order center for processing service orders and inquiries." *Id. See also KCC Final Order* at 32 ("variances between Kansas [NRC] prices and other states should be limited"); *KCC NRC Order* at 2 ("Prices should be similar for similarly defined elements, especially for those cost elements that use common resources within the five SWBT states: Texas, Missouri, Arkansas, Oklahoma and Kansas); *id.* at 24 ("it can be appropriate to rely upon the examination by other state commissions facing similar facts and circumstances").

81. Yet the differences between the two SWBT states are enormous. In Texas, the loop NRC is about $15; in Kansas, the same NRC over $30. The NRC for a basic

analog loop to port cross-connect is a little more than $4 in Texas, but over $26 in Kansas. Again and again, the Kansas NRCs are two, three or four or more times higher than the NRCs for the same elements in Texas.

VI. CONCLUSION

82. In sum, SWBT cannot satisfy its burden of showing that its UNE rates are just and reasonable and based on the efficient forward-looking cost of providing network elements. SWBT's recurring and non-recurring rates for UNEs in Oklahoma, which were lifted from a nonunanimous stipulation unsupported by any cost study and which are as much as double the equivalent Kansas rates, are plainly not cost-based. The OCC ALJ's split the baby approach does not cure this problem. Although the KCC generally applied forward-looking TELRIC principles in setting recurring UNE charges, it established non-recurring charges using grossly inflated SWBT proposals that the KCC itself had found to violate TELRIC principles.

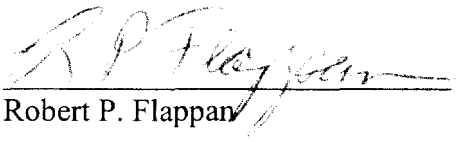
I, MICHAEL R. BARANOWSKI, hereby declare under penalty of perjury that the foregoing is true and correct to the best of my knowledge and belief.

Michael R. Baranowski

MICHAEL R. BARANOWSKI

November 14, 2000

I, Robert P. Flappan, hereby declare under penalty of perjury that the foregoing is true and correct to the best of my knowledge and belief.



Robert P. Flappan

November 14, 2000